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In the circumstances, what is surprising is that the evident weaknesses in the credit structure could persist so long without more serious adverse consequences for economic activity . . . One clear danger is that a natural self-healing process of pulling back from excessive aggressive lending practices could spill over into a destructive retreat from ordinary prudent credit extensions.

Paul Volcker
Wall Street Journal, October 17, 1990

HIGHLIGHTS

The recent dollar-surge — particularly against the DM — prompts a critical question: Is it a move based on sustainable fundamentals? Our reading of the evidence suggests it is nothing more than a speculative bubble comprising little in the way of bona-fide capital flows.

Foreign private investment in the United States virtually collapsed in 1990 while U.S. net private investments abroad increased. That was the real cause of the dollar's decline. Like in 1987, only the large scale dollar purchases of foreign central banks rescued the dollar from a crash.

Relative aspects of demand and supply conditions outweigh inflation expectations. On that basis, the unprecedented gap between total budget deficits and available national saving is a bad omen for the U.S. bond market and long-term interest rates despite collapsing private credit demand.

Given that the combined federal, state and local deficits have trebled since 1989, it seems pretty sure that net national savings must now be close to zero. What that would mean is this: any net new internal capital formation in the U.S. must depend on capital inflows.

What matters crucially for an economy's long-term health, strength and competitiveness are savings, investments and the price-cost relations determining the return on investment.

The drastic decrease in available savings will sharply increase the U.S. economy's inflation bias. Ultimately, it's the rate of saving that sets the limit to non-inflationary growth.

The argument that the shrinking U.S. current-account deficit will buoy capital inflows and support the ailing bond market by boosting confidence in the U.S. dollar is highly fallacious. In a world of booming capital flows, it is prospects for the capital account that matter more.

The presumption that the U.S. economy is reliquefying is grossly inconsistent with the extremely weak growth trends of credit and the wider money aggregates. All that's happened so far is that liquidity outside the banking system has been shifted around.

One should remember that the D-mark enjoys its most substantial interest rate advantage since 1973-1974. Then, the dollar collapsed. Today, popular theory has it the dollar should appreciate.

Record-high U.S. budget deficits and an aggressive monetary easing that fails to restimulate the economy is a sure recipe for one thing: a falling dollar.

DOLLAR: SPECULATIVE BUBBLE OR NEW UPTREND?

The time has come to seriously think about the true causes of the U.S. dollar's sudden recent bull-run. What was it? A speculative bubble based on nothing more than empty euphoria and crowd psychology or the beginning of longer-term uptrend based on improved and improving cyclical and structural fundamentals?

To be sure, the crowd firmly believes in the latter scenario. Nine out ten forecasters publishing their currency forecasts in the past two to three months had been calling for the U.S. dollar to rise to DM 1.80 by year-end and still higher thereafter.

THE BULLISH CASE FOR THE DOLLAR

The widely accepted bullish case for the dollar against the D-mark commonly consists of three major components as follows:

1. Anticipation of an impending reversal in the relative cyclical conditions between the United States and Germany. The U.S. economy is supposed to take off while the German economy begins a weakening phase associated with sharply narrowing economic-growth and interest-rate differentials.

2. Increasing doom and gloom about the German economy, above all in connection with unification. In this view, the current negative impact of transitional distress in east Germany is basically seen as the reversal of the positive impact on the German currency of prior unification euphoria.

3. Last but not least, the bullish dollar forecasts are regularly bolstered with the argument that the U.S. dollar is grossly "undervalued" both against the yen and the D-mark when measured by relative domestic purchasing power.

We do not agree with any of these arguments. In the first place, we rigorously dissent with the spreading view that the DM's past rise against the dollar had been driven by a euphoric response of international markets to German unification.

As far as foreign sentiment is concerned, the truth is that ever since German unification came into sight, international analysts and media have indulged in varying horror stories about its terrible implications for Germany's economy and currency. The bogey then was the scaremongering on uncontrollably escalating inflation pressures. Now, the new bogey is the prospect of a collapsing east German economy.

To start with, there never was any doubt that German unification would involve enormous outlays. True, unification costs are proving to be higher than expected. Yet, it's vital to consider such needs within the context of Germany's extraordinary financial capability. The straightforward and most important fundamental is that even larger public borrowing requirements are comfortably matched by a huge domestic savings surplus.

Considering all the agitation about Germany's "disastrous" budget deficit, it itches us to draw a comparison with the fiscal situation in the United States where a exploding budget deficit hardly stirs any critical comment at all. Apparently, there are two kinds of budget deficits. German deficits doom the economy and the currency yet far larger deficits in the U.S. — both absolutely and relatively — are irrelevant.

FINDING THE REAL FISCAL DISASTER

Over the last two years, the U.S. federal budget deficit has virtually spiralled out of control. Official forecasts put this year's deficit at around $300 billion following a deficit of $165 billion last year.

Federal finances are not the only budgets spiralling out of control. The same goes for state and local deficits. In 1986, these governments had a net surplus of $62.5 billion including the large surpluses that cumulated in their pension funds (amounting to $70 billion annually). Ever since, these surpluses have increasingly been eaten up by soaring operational deficits.

Here are a few figures that put a scope on the present U.S. fiscal situation; what we can only call a disaster. In the calendar year of 1989, the federal deficit amounted to $134 billion and net state and local surpluses combined to a total of $46 billion. That left a net public borrowing requirement of about $90 billion. This year, the federal deficit is estimated to hit $300 billion. In the interim, little is expected to be left of the state and local surpluses. That makes for a swing in public borrowing requirements of nearly $200 billion.

The key in properly comparing fiscal situations is in employing a valid bench mark. It has become customary to measure budget deficits against a country's GNP. On this basis, budget deficits amount to 5.5% of GNP in the U.S. and, in the German case, to a marginally higher ratio of 5.7%.

We hasten to add, though, that using GNP as a measuring rod is grossly misleading and nonsensical. What matters from a long-term perspective of economic growth and inflation is the extent to which budget deficits are covered by domestic savings. In other words, how much savings remain available to support productive investment.

In the United States, the budget deficit of about $300 billion compares with abominably low personal savings which are running at an annual rate of less than $170 billion.

In Germany, by contrast, the public sector deficit of DM 150 billion correlates with considerably greater personal savings of about DM 250 billion per annum.

Given the fact that international and American economists so tenaciously ignore the U.S. fiscal disaster, one cannot expect them to anticipate the long-term consequences either. Since that's the case, we thought that we should do it for them. In exploring this question, though, we notice that we have some good company in America. In its last Quarterly Review, the Federal Reserve Bank of New York published a study entitled <u>The Decline in U.S. Saving and its Implications for Economic Growth</u>. That, precisely, is our question . . . only, we would also address the implications for inflation and the balance of payments.

It strikes us as odd that this report by the New York-Fed has not received even the slightest publicity in the media or bank and broker reports. Its message is far too horrible and too much in conflict with the current euphoria.

Frankly speaking, most American economists talk too much about economic trivialities for our taste. Simply, what matters crucially for an economy's long-term health, strength and competitiveness are three things: savings, investments and price-cost relations determining the return on investment.

Table I

U. S. NATIONAL SAVING (PERCENT OF GNP)

	Households	Corporations	Private	Government	Net
1962-73	5.6	2.2	7.8	-0.5	7.3
1974-79	5.6	2.7	8.3	-1.5	6.8
1980-84	5.5	1.6	7.0	-2.9	4.1
1985-89	3.9	1.4	5.2	-2.9	2.3

Source: Federal Reserve Bank of New York, Winter 1991, Volume 15 No 3-4.

At first glance, the above table (which we've reproduced from the New York-Fed report) reveals a virtual massacre of available savings for new investment. From the 1960s to the late 1980s, U.S. net national savings — the sum of household and corporate saving minus public deficits — have virtually collapsed from 7.3% of GNP only to 2.3%. Taking into account — as already explained — that the combined federal, state and local deficits have trebled since 1989, it seems pretty sure that net national savings must now be close to zero. What that would mean is this: any net new internal capital formation in the U.S. must depend on capital inflows.

What are the inevitable consequences of such a savings deficiency. For some conclusions we would like to give the first word to the authors of the Fed study:

> *Low saving has not caused a sudden collapse in the economy, but it has caused a steady erosion of the nation's growth potential accompanied by a sharp increase in net indebtedness to foreigners.*
>
> *In practice, the large U.S. current deficits of the 1980s mainly reflected high U.S. consumption.*
>
> *By 1989, low saving has cost the U.S. economy about 15% of its capital stock lowering potential output by about 5%. By the end of the century, if the status quo continues, the accumulated loss in capital and output will grow to at least 28% and 10% respectively.*
>
> *A healthier economic outlook will require redirecting all kinds of spending toward investment — not only in plant and equipment, but also in infrastructure, environmental safeguards, and research.*

Now let's translate these general conclusions of the Fed-authors into some specific conclusions for the financial and currency markets:

The rapidly-growing, unprecedented gap between total budget deficits and available national savings is an ill omen for the U.S. bond market and long-term interest rates despite the fact that private credit demand has virtually collapsed.

Ominously, three discount rate cuts in rapid succession since mid-December coupled with a generous supply of bank reserves have completely by-passed the bond market. After such a hefty monetary barrage, long-term interest rates remain virtually unchanged. In the meantime, the spread between short and long-term government paper has steepened from 1 to 2.8 percentage points.

Most economists offer the comforting conclusion that this large yield gap shows how stimulative the Fed's policy is and that, therefore, an economic recovery is a certainty. The problem with this light at the end of the tunnel, as has been said before, is that at first sight it isn't always clear if it's daylight or an approaching train.

In this case, it seems far more logical to assume that the sharp rise of the yield gap reflects excessive budget deficits which, rather than foreshadowing a recovery, signals a potential crowding out of private investment.

U.S. PRIVATE LONG-TERM FLOWS, 1986-90
(U.S. DOLLARS IN BILLIONS)

	1986	1987	1988	1989	1990
Net Inflows*	108.9	81.4	105.0	141.8	31.1
Stocks	17.2	15.6	- 0.5	6.6	-14.8
Bonds	57.6	18.9	47.0	63.0	20.1
Direct Investment	34.1	46.9	58.4	72.2	25.7
Net Outflows**	-23.0	-36.3	-24.1	-53.7	-62.8
Stocks	- 1.3	2.1	- 0.9	-16.7	- 6.1
Bonds	- 3.0	- 7.4	- 6.9	- 5.3	-20.4
Direct Investment	-18.7	-31.0	-16.2	-31.7	-36.4
Balance	85.9	45.1	81.0	88.1	-31.8
Stocks	15.9	17.7	- 1.4	-10.1	-20.9
Bonds	54.6	11.5	40.1	57.6	- 0.2
Direct Investment	15.4	15.8	42.2	40.5	-10.7

* Net foreign purchases of U.S. assets.
** Net U.S. purchases of foreign assets.

The point which American and international economists studiously ignore in this context is that the underlying supply and demand conditions in the U.S. bond market have deteriorated dramatically. Looking at it from this angle the truly astonishing thing is that bond yields have not moved higher.

But the flood tide of new issues arising from exploding budget deficits is not the only thing that plagues the U.S. bond market. At the same time, it has lost its biggest buyer: the foreign central banks and investors. A look at Table II on the previous page leaves little doubt.

ON THE TRAIL OF CAPITAL FLOWS

Revealingly, the same table also shows the true cause of the dollar's decline against the D-mark last year: a drastic reversal in the U.S. capital account. In 1990, private long-term capital flows shifted to a net outflow of $32 billion from net inflows of $88 billion in 1989 and $81 billion in 1988.

Foreign private investment in the United States virtually collapsed to $31 billion in 1990 from $142 billion during the previous year. U.S. net private investments abroad increased from $54 billion to $63 billion. To repeat, that shift in capital flows was the chief underlying cause of the dollar's persistent decline.

One should ponder this: Considering that the $32 billion deficit of the long-term capital account comes on top of a current-account deficit of $99 billion, the dollar, if left to market forces, would have literally collapsed late last year. Why didn't that happen? Again, as in 1987, the dollar was rescued by foreign central banks, who, without publicity, stepped in with large dollar purchases. These purchases had even escaped our own attention because we had focused on the U.S. capital-account statistics which, for 1990, showed these purchases at a relatively moderate scale of $30 billion. But according to the Fed's own statistics, foreign central banks increased their assets held at Federal Reserve Banks between January 1990 and January 1991 from $224 billion to $286 billion, or $62 billion. That's a sizable difference that holds a real impact.

Let's get back to the implications for the U.S. bond market and long-term interest rates. In supporting the dollar, the central banks really financed large parts of two different deficits: first, the current-account deficit, and secondly, the budget deficit. In effect, these banks replaced the natural foreign private investor who had turned away from U.S. securities markets. The result? These activities served to support both the dollar and the U.S. bond market.

Now that the dollar has seen a reprieve and that the foreign central banks have ceased their dollar purchases, the U.S. bond market is remiss of its biggest buyer of the past few years. As a result, great hopes are now pinned on the comeback of the foreign private investor. It has become a widespread fallacious argument that the shrinking U.S. current-account deficit will serve to enhance confidence in the dollar. Fallaciously, the thinking goes that any boost in confidence will buoy capital inflows again, and, in tandem, also support the ailing bond market.

THE CURRENT ACCOUNT DEFICIT: EATING THE GOLDEN GOOSE

American economists are great in conjuring up rosy scenarios for their own economy. This time, they flippantly overlook the salient point that a shrinking current-account deficit and rising capital inflows

are stringently exclusive of each other. Because they are exact counterparts in the balance of payments they must move conversely. Wall Street's dream of a disappearing U.S. current-account deficit implies net new capital inflows of essentially zero to the U.S.

Ironically, Wall Street will be the greatest loser if the U.S. current-account deficit would disappear. These deficits were the source for the hundreds of billions of dollars flowing abroad which foreign investors — through the agency of Wall Street — poured right back into U.S. stocks, bonds and corporate takeovers.

Crucially, one shouldn't forget that the persistently large current-account deficits had two important beneficial effects on the U.S. economy.

1. The huge import surplus helped to suppress inflation by providing a release valve for excess domestic demand. Imports added massively to the supply of goods for domestic consumption meaning that Americans could buy more goods for their income.

2. The associated huge capital inflows tended to keep interest rates lower than they would otherwise have been.

Essentially, the declining import surplus now exerts the opposite effects. Drastically cutting the supply of foreign goods and capital tends to raise both inflation and bond yields in the United States. Almost surely, this is a main reason for the disappointing performance of the two.

Let's illustrate this point with a short, simple calculation about America's future expected net capital supply from domestic and foreign saving. As shown in Table I on page 4, between 1985-1989, U.S. net national saving amounted to 2.3% of GNP. Adding foreign capital inflows to this amount, total net capital supplies — comprising both foreign and domestic sources — added up to 4.1% of GNP. Such a capital supply is horribly low by international standards.

Yet, as grim as the implications of the past savings deficiency already are, the future outlook is a lot worse. In short, it's devastating. Remember what we said about the exploding federal, state and local deficits. On top of this internal fiscal disaster is the added impact of sharply lower capital inflows. On balance, doing the sums, we wonder whether there will be any net savings left at all.

You can be sure that this catastrophic savings imbalance will have far-reaching, long-term implications. We anticipate two kinds of developments:

1. A grossly intensified crowding-out of private investment by public borrowing. During the 1980s, massive inflows of foreign capital — in excess of $800 billion — served to largely fill in the shortfall of domestic saving and thereby moderated the negative impact of the budget deficits on domestic investment.

2. The virtual absence of net saving and net investment foreshadows even lower productivity gains and severely aggravates the U.S. economy's already high inflation bias.

THE SOURCE OF THE RECENT DOLLAR RALLY

But doesn't the recent surge of the dollar strikingly contradict our pessimistic assessment of the capital account? Doesn't it prove the opposite; that the foreign investor is back in full force? We don't think so. Anecdotal evidence and the extraordinary speed of the dollar's move suggests that one-sided forward-buying and hedging transactions by the inter-bank market, corporations and global fund managers were the main impetus. In short, the whole phenomenon was mainly a speculative currency play in dollars against the D-mark, marked by little bona fide capital flows entailing purchases of U.S. bonds and stocks.

The big bullish arguments for the dollar — apart from an alleged cyclical recovery — rests mainly on a sharply declining trade deficit and sharply higher real interest rates; the latter purely a function of optimistic inflation forecasts.

So far, only the improvement in the trade balances has come about. However, the expected U.S. rebound and the convergence of German/American inflation rates remain as castles in the air. Even though U.S. domestic demand has fallen at an annual rate of 4.5% over the past two quarters while, conversely, German domestic demand has soared by the same percentage, German inflation is still at 2.8% year-over-year versus 5% in America. Even a deep recession has been unable to produce the boom-time inflation rate of Germany. A longer-term perspective is even more illustrative. Taking the 1982-84 period as a basis, consumer prices have since risen by 14.5% in Germany while rising 35% in the United States. All that talk of an imminent American/German inflation convergence is really quite ridiculous.

Our medium-term currency outlook presently is framed by two questions: first, the timing and strength of a U.S. economic rebound; and second, the relative influences of the capital and current accounts on the net balance of payments and consequently on the exchange rate.

As we often have expressed, one tenet remains true; the U.S. business cycle has been one of the surest influences on the U.S. dollar. Generally, the dollar has risen when the U.S. economy pulled out of recession ahead of Europe. Remarkably, that happens even though the cyclical upturn typically weakens the U.S. current account. The element that usually tips the balance in the dollar's favour is accelerating capital inflows. Due to interest rate movements, the U.S. capital account tends to improve by more than the current account deteriorates.

While we fully agree with this theory of cyclical influences on currencies in general and on the dollar in particular, our points of contention lies with the dollar-optimist's assumptions of an impending U.S. cyclical recovery and that it will stir meaningful capital inflows into the U.S..

THE U.S. ECONOMY: NO MEANINGFUL RECOVERY IN SIGHT YET

Those who still subscribe to the notion that U.S. economic activity will rebound shortly have been heavily emphasizing the implications of improving consumer confidence, rising money supply and the verdict of a sharply rising stock market since mid-January when the Dow languished below 2500.

We are not impressed by any of these arguments. As for the stock market, evidently, the Gulf victory

has triggered an euphoria. At the same time, Wall Street brokers have been quick to whip up the public's bullishness with the argument that "excess liquidity" warrants rising stock prices. Of course, as stock prices rise bullishness becomes self-generating and self-perpetuating . . . at least for a time. The influence of positive psychology is not new.

Our opinion about the present fireworks on Wall Street was best expressed by Joseph Schumpeter long ago during a similar craze in the 1920s: *"The mere fact that a small group of people entertain an irrationally high opinion about the value of a stock can, with very small transactions, raise it to indefinite heights without absorbing any funds or credit facilities. Barring new issues, comparatively small amounts will go a long way on the stock exchange. Considerable booms can develop on a narrow basis of "cash".*

ONCE AGAIN: MONEY SUPPLY CONTRADICTIONS

We also dispute Wall Street's supposition that the recent rises in M1 and M2 reflect a reliquification of the economy. As we already pointed out in our last letter, this presumption that the U.S. economy is reliquefying is grossly inconsistent with the extremely weak trends seen within the credit and wider monetary aggregates.

The only way that non-banks — that is corporations and consumers — can reliquefy as a whole is through the increased credit and money creation of the banking system. Their overall liquidity cannot grow unless banks expand their loans and investments. If loan demand is weak during the recession, the money and liquidity creation through the banking system regularly shifts from loan expansion to investment expansion. In fact, just that is happening but at a much more moderate scale than in former recessions.

Even worse is a second abnormality that's become obvious: an unprecedented collapse in bank lending. Over the last 12 months, loans and securities at all commercial banks expanded 4.5%, over the last 6 months at 2.8%, and only 2.2% over the recent 3 months. Not only is the credit crunch still in force, it is actually worsening.

What does that all mean? In a nutshell, it means that the Fed's big liquidity injections into the banking system are getting lost. For whatever reason, easier money is not getting passed through to the economy.

By comparison, during the last recession year of 1982 bank loans and investments expanded by 7.3%. In the first recovery year of 1983, these asset categories picked up the pace to a growth rate of 10.8%.

What should we make of the recent acceleration of M1 and M2? Not very much. Given the extremely weak bank expansion, there is only one reasonable explanation for this apparent trend: Individuals and corporations are probably converting illiquid assets into more liquid assets since overall liquidity is so inadequate.

THE KEY ROLE OF THE BANKING SYSTEM

The counter argument of many economists to these ominous monetary developments is to simply play

down the role of the commercial banks in the credit system. They fail to realize that the commercial banks are the central cog in the monetary transmission mechanism between the central bank and the economy. The supply of money can only grow — that being the indispensable condition for an upswing — when banks lend or invest in association with the creation of new deposits. It's a fact that since last summer, the banking system has allowed excess reserves to rise to a degree unprecedented since the 1930s.

Our readers are familiar with the reasons why we are sceptical of any significant rebound in the U.S. economy over the foreseeable future. It would be poor use of space to discuss all the statistical jiggles that have put Wall street into ecstasy. Much of it, by the way, is the obvious mirage created by questionable seasonal adjustment. Thus, it was seasonal adjustment that magically turned an actual decline in durable goods orders of $4.5 billion(or 3.7%) in April into an increase of $3.3 billion (or 2.9%).

WHAT NEEDS TO HAPPEN

Wall Street would do better to focus on the one question that matter most in this situation: What has to happen to pull the U.S. economy out of this unique recession?

As we have always said, the fundamental, deeper-seated causes of this U.S. recession undoubtedly lie in the debt excesses of the previous boom. These excesses have given life to three key factors that act to constrict recovery potential: an income squeeze, a profit squeeze, a credit squeeze — all three self-reinforcing and cumulating into a vicious cycle.

Although a number of important reasons underpin our scepticism of an economic upturn in the U.S., we focus here on the one that is most important. Its resolution and quick remedy is the most essential, in fact, indispensable. That's a decisive reversal of the still-worsening credit crunch. Recent bank figures were the worst yet. Unbelievably, in April, total loans and securities at all commercial banks increased from $2,750.9 billion to $2,751.6 billion, or $700 million, which amounts to an expansion of essentially zero.

Either the Fed succeeds in getting bank credit growing again at a respectable rate very soon or the recession is bound to deepen further. Only a credit expansion makes it possible for expenditures to increase beyond incomes and so lead to an increase of demand and production. As long as both incomes and credit shrink, forget about any upswing.

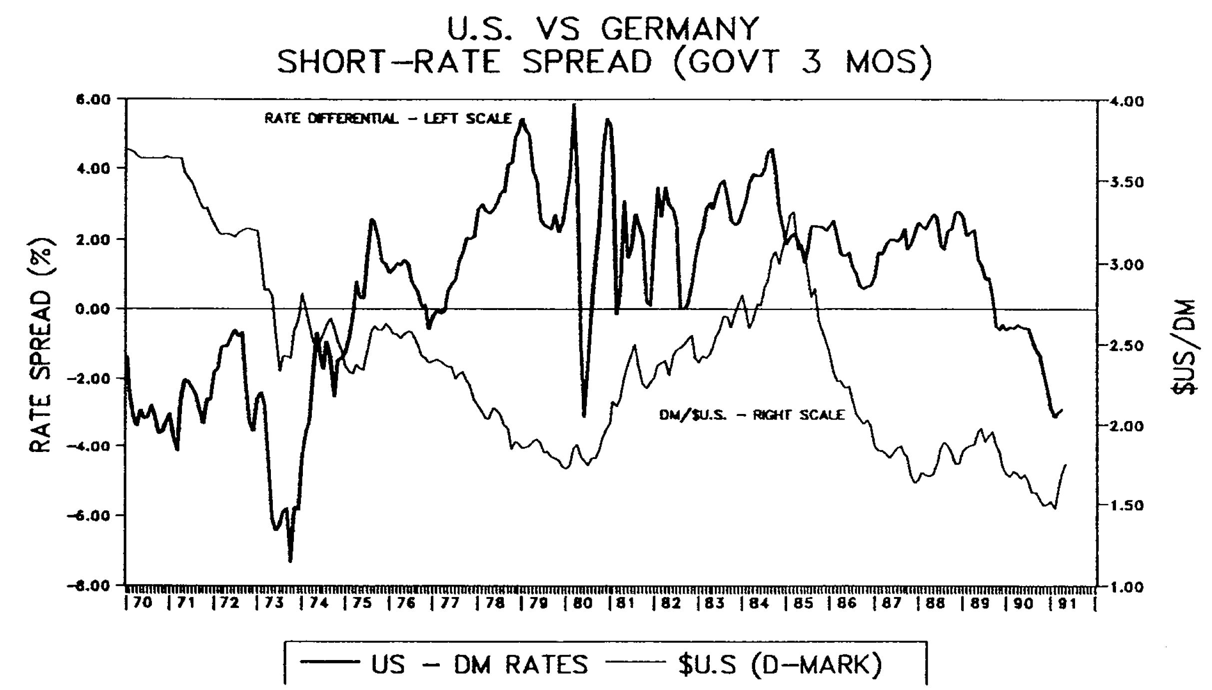
BACK TO THE DOLLAR QUESTION

What will happen if the U.S. economic rebound fails to turn up? Quite flatly, the key assumptions underpinning the recent speculative run in the dollar simply evaporate into thin air. A deepening recession would compel the Fed to ease further. The German/American interest rate differential would increase rather than narrow.

In any case, to the extent that international traders will become sceptical about the timing and the strength of the predicted U.S. economic rebound, the speculative dollar positions based on borrowed D-marks becomes increasingly vulnerable. Short-term DM-interest rates are already 3 1/16% higher than

dollar rates — a disadvantage that doesn't matter as long as the dollar-holder anticipates higher compensating currency gains. The trouble starts when continued currency gains begin to appear doubtful — that is, when the markets lose their faith in the U.S. economic rebound.

On that topic, one should remember that the D-mark enjoys a substantial interest rate advantage for the first time since 1973-74. Then, the dollar collapsed. Today, popular theory has it that the dollar should appreciate. The graph on this page depicts the trend of the DM/$ relationship with the short-term interest-rate differential.



Source: Hahn Capital Partners

The latest argument, though, has it that the declining U.S. trade deficit will buoy the dollar over the longer-run while the declining German surplus is said to undermine confidence in the D-mark. All the evidence, though, says that the capital account dominates the current account, not the other way around. During the 1970s, in fact, the dollar collapsed even though the U.S. current account was some years in surplus.

Germany's D-mark has often been at its weakest when it had the highest current account surpluses. In recent years, the countries with the highest current-account deficits — Canada, Australia, Spain, Italy etc. — had the strongest currencies. The obvious reason was that high interest rates attracted more capital inflows than were required for the financing of their respective deficits. The evidence is very strong that the capital account is the most crucial in determining the value of a currency. And, capital flows are essentially more variable and mercurial than trade flows and much more sensitive to psychological influences.

The dollar's fall last year has been entirely consistent with the usual cyclical pattern. The developing

recession associated with a progressive monetary easing did weaken the U.S capital account by far more than the current account improved. Earlier, we showed the dramatic impact on the capital inflows in Table II on page 5.

If the U.S. economy remains mired in recession, as we assume, this may well bring further improvements in the current account. But that would be outflanked by the capital account's further weakening. In our view, attracting substantial private foreign capital to the United States would require a relatively strong U.S. recovery and a substantial narrowing — if not the reversal — in interest rates differentials than is likely.

CONCLUSIONS

Until quite recently, predictions of an impending U.S. recovery were based on three main features: improving consumer confidence, rising money supply and, in particular, the implications of a bullish stock market, which has been hailed as the infallible guide to the economy's cyclical movements.

As we have said before, we are not impressed by any one of these arguments. In the first place, the view that the stock market has perfect predictive powers becomes increasingly ridiculous when one sees that just about every stock market around the world has been going up, including those countries experiencing deepening recessions. In fact, recession countries have among the strongest stock markets.

The economic issue at stake in America is much more than just the next cyclical upswing. It has also to do with the longer-running implications of lower growth and higher inflation. The depressing effects impacting the economy are largely chronic and structural. America's prosperity in the 1980s was based on a credit-fed asset price inflation that fuelled overconsumption at the expense of productive investment.

Just think of the impact of a record-high budget deficits and an aggressive monetary easing failing to restimulate the economy. Undoubtedly, that combination is a sure recipe for one only thing: a falling dollar.

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